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Lessons From Canadian Mineral Taxation:
An International Context

Remarks
for the Presentation

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Canada

Foreword

This presentation was prepared at the request of the United Nations Economic Commission for Europe.

The issues addressed and the topics covered in this paper have been selected to reflect questions which are often raised in transition economies. With a well-developed mining industry and a mining tax system that has been honed throughout the years, Canada's mining taxation experience is worth studying by countries that are reviewing their tax treatment of mining.

The field of mineral taxation is a complex one. It does not lend itself easily to interpretation, whether at the level of the individual provision or at the level of the entire tax regime. Complex interactions among various tax provisions are not always obvious as to their final implications for corporations and investors.

In order to reach a better understanding of these interactions, Natural Resources Canada has been working on quantifying the effects of relevant tax provisions that apply to mining activities. Studies have been made of a number of mining jurisdictions across the world to enable decision makers to clearly understand the implications of tax changes on the competitiveness of a particular tax regime. These studies highlight the necessity of fully understanding the complexities of mining taxation before passing judgement on the appropriateness of a particular tax regime.

These remarks are for discussion purposes only. They should not be considered an expression of official views of the Government of Canada.

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Section 1

Introduction

LESSONS FROM CANADIAN MINERAL TAXATION:

AN INTERNATIONAL CONTEXT

1.1 Introductory Remarks

- I am happy to be here today to discuss the evolution of the Canadian mineral taxation regime and to share with you some of the lessons that we have learned over the years.

- In Canada, mining activity has long been recognized for its ability to create jobs, build infrastructure and develop regions.

- The economic and social benefits of mining have led successive Canadian governments to acknowledge the specific risk characteristics of the industry through the tax system.

- Supportive mineral taxation regimes have been instrumental in the development of what is today the largest mineral exporting industry in the world, and a very important component of Canada's economy and way of life.

- Let us start this presentation by looking at the principles that have guided the evolution of mineral taxation in Canada.

- For simplification purposes, I have chosen to discuss the federal income tax regime as an illustration of the Canadian experience. The provincial experience is brought into play only when it differs significantly from the federal one.

Section 2

Evolution of the Canadian Mineral Taxation Regime

Framework of Canadian Mineral Legislation

- **Private Sector Determines the Pace of Mineral Development**
- **Government Plays a Complementary Role**
- **Rules and Regulations Are Known in Advance**
- **Industry Is Consulted on Proposed Modifications**

2.1 Framework of Canadian Mineral Legislation

- The basic premise behind Canadian mineral legislation is that the pace of mineral development is largely left to the initiative of the private sector.

- Through heavy experience, the government has learned that it is impossible to predict which projects will be most profitable. Therefore, rules and regulations are drafted according to the principles of free enterprise, where the private sector essentially dictates the allocation of resources in the economy.

- The role of the government is of a complementary nature. Government provides the regulatory and fiscal framework under which the industry can develop and prosper.

- This implies that companies know in advance the rules and regulations under which the industry will operate. In Canada, companies generally know, before they consider an investment, what rules and regulations will apply to their projects. This facilitates the planning process and reduces the uncertainty associated with the possibility of change. It also eliminates the need for negotiations at the project level between government and companies.

- Of course, there are always some provisions that need to be added, updated or revised to take into account the dynamic world in which we live. Generally, modifications are incremental and implemented in such a way as to minimize the effect on the overall fiscal framework.

- It is important to note that the industry is very much involved in the drafting of any change to the tax regime. Therefore, when a modification is deemed necessary, the industry is given every chance to provide its input. This results in modifications to the tax regime that are fully expected and which can be accommodated by industry.

- For instance, in the 1996 Budget, the federal government introduced three relatively minor changes to mineral-related tax provisions. All three were negotiated beforehand with industry, and all three received industry's approval upon their announcement in the Budget.

- Overall, I would summarize the Canadian approach as one in which the basic taxation rules are well laid out and generally apply to every project.

Evolution of Tax Provisions for Mining

Tax Provision	Pre-1972 Tax Reform	Post-1972 Tax Reform	Post-1987 Tax Reform
Tax holiday for new mines	3 years	Repealed	No
Automatic depletion	33⅓%	Repealed	No
Earned depletion	No	33⅓% (to max. of 25% of resource profits)	Repealed
Mining Exploration Depletion Allowance (MEDA) (Effective April 1983)	No	33⅓% (to max. of 25% of any income)	Repealed
Tax exemption of prospectors' and grubstakers' proceeds	Yes	Exemption replaced by capital gains treatment	Capital gains treatment
Taxation of investors' capital gains	No	50% inclusion rate	75% inclusion rate
Write-off for exploration and preproduction development expenses	100%	100%*	100%
Write-off for post-development and production expenses	Current Expense Treatment	Class 12 100%	30% CDE
Accelerated CCA for new mines and major expansions	No	Yes	Yes
CCA rates for replacement assets	30% D.B.	30% D.B.	25% D.B.
General and regional investment tax credits	No	General 7% Regional 10-20%	Regional only (10% in Atlantic Region)
Deductibility of provincial mining taxes	Yes	Replaced by 25% resource allowance	25% resource allowance

* From 1974 to 1978, the write-off for pre-production development expenses was reduced to 30% declining balance.

2.2 Evolution of Tax Provisions for Mining

- Government's socio-economic policy objectives, the 1972 and 1987 tax reforms, as well as international competition for investment have been the major factors influencing mining-related tax policy over the years.

- The federal income tax changes that have been made since the early 1970s reflect the policies that prevailed at different times during that period, including times of economic stimulus as well as times of restraint and major tax reform.

- Specific tax measures, such as depletion and the three-year tax holiday, were targeted at the mining industry to stimulate investment growth. They have been repealed as a result of the 1972 tax reform under which the concept of "neutral taxation" became more prevalent.

- However, other measures were introduced such as (i) the accelerated capital cost allowance that replaced the much lower rate of depreciation that applied under the 3-year tax holiday; (ii) the earned depletion (since repealed), which was calculated as a percentage of investment; (iii) the 100% write-off of exploration and pre-development expenses.

- These measures were designed to recognize the high risk character of mineral investment and its peculiar income measurement problems. The accelerated capital cost allowance and the 100% write-off of exploration and pre-development expenditures are still in effect today.

- The deductibility of provincial royalties, which was removed in 1974 to prevent the erosion and unpredictability of income tax revenues, was replaced in 1976 by a 25% resource allowance on federal and most provincial income taxes.

- Since the 1987 tax reform, the mineral taxation regime has been moving further towards a level playing field with the other sectors of the economy. However, Canada still maintains a certain number of tax provisions that recognize the risks involved in mineral exploration and mine development.

- By continuing to offer such provisions, successive governments have recognized the importance of the mining industry to the country.

Section 3

Structure of the Current Mineral Taxation Regime

Sharing of Resource Taxation

- **Federal Government**
- **Provincial/Territorial Governments**
- **Local Governments and Municipalities**

3.1 Sharing of Resource Taxation

- The Canadian taxation regime for mining is complex because the Canadian Constitution gives corporate income taxation powers to both the federal government and the provinces/territories while taxation powers over natural resources belong only to the provinces/territories.

- Since each province/territory taxes corporations and mining activity according to its own specific objectives and policy orientations, there are, in fact, twelve different taxation regimes for mining in Canada, one for each province or territory.

- The federal government levies a corporate income tax on mining corporations as well as on all other corporations in the economy.

- In addition to levying their own corporate income taxes on all corporations, provinces/territories levy mining taxes and royalties on mining corporations.

- Although the provincial mining taxes are all essentially profit-based, each province/territory has its own distinct mining tax structure. Some provinces, such as Ontario, Quebec and Manitoba, impose royalties at the corporate level; other provinces do so at the mine level.

- The taxes paid under any of these regimes cannot be deducted in determining the taxable income for another regime. When computing federal corporate income tax and provincial corporate income tax (in most provinces), a resource allowance of 25% of resource profits is used to compensate for the burden of mining taxes paid to the provinces/territories.

- In addition to income and mining taxes, a number of nonprofit taxes and levies are imposed on mining and other corporations by the federal, provincial/territorial, and local governments. Examples include sales taxes, fuel taxes, payroll taxes, and capital taxes.

The Tax Base

- **Expenses and Costs Considered as Normal Costs of Doing Business are Generally Allowed as a Deduction**

- **Tax Treatment of a Mining Expense Depends on When the Expense Was Incurred**

- **Preproduction Expenses Result in 100% Deduction**

- **Expenses in Production Period Get Variable Rates of Depreciation Depending on the Type of Expense**

3.2 The Tax Base

- The key to understanding the approach taken by the taxing authorities to mining in Canada lies in understanding the tax base, which can be generally defined as a measure of income upon which a tax rate is applied.

- The tax base is also known as "taxable income". For mining operations, taxable income for income tax purposes is equal to gross income from all sources less: operating costs and other business expenses; allowances for depreciation of capital expenditures; mining exploration and development costs incurred in Canada, and allowances for foreign exploration expenses; net interest expenses; and, losses that may be carried forward from previous years.

- Mining taxes and royalties paid to the Crown are generally not deductible, but a special provision exists that allows a percentage of resource profits to be deducted in lieu of the amount of mining tax/royalty paid.

- The tax treatment of a mining-specific expense depends on whether in the first instance we are talking about the "preproduction period" or the "period of production".

- The point of demarcation between these two periods is the date of commencement of commercial production (in reasonable commercial quantities).

- Within this framework, different treatment is given to expenses incurred for exploration, for development, for the purchase of production assets before the commencement of production, for the replacement of production assets, and for a major expansion of a mine.

Total Tax Burden

Federal Corporate Income Tax

+

Provincial/Territorial Corporate Income Tax

+

Provincial/Territorial Mining Taxes/Royalties

+

Nonprofit Taxes and Levies

3.3 Total Tax Burden

- The total tax burden resulting from federal corporate income tax, provincial/territorial corporate income taxes, mining taxes and other levies is additive in respect of certain mining profits.

- It is important to note that provincial mining tax regimes are generally designed to collect taxes only at the "mine mouth". This result is achieved by means of processing allowance provisions, which exempt, from mining taxes, the profits attributable to concentrating, smelting and refining operations.

Tax Provisions Applying to the Mining Industry

Federal

■ **Canadian Exploration Expenses (CEE)**	**100%**
■ **Canadian Development Expenses (CDE)**	**30% D.B.**
■ **Capital Cost Allowance (CCA)**	**25% D.B.**
■ **Accelerated Capital Cost Allowance (ACCA)**	**Up to 100% D.B.**
■ **Operating Expenses**	**100%**
■ **Non-Capital Loss Carryovers**	**7 Years Forward, 3 Years Backward**
■ **Resource Allowance**	**25% Write-Off of Resource Profits**
■ **Flow-Through Shares**	**CEE Deductions Transferred to Investors**
■ **Mine Reclamation Funds**	**100%**

Provincial/Territorial

■ **Deductions, Allowances, Loss Carryovers and Flow-Through Share Benefits**	**Mostly Same Treatment + Special Provisions in Some Provinces**

3.4 Tax Provisions Applying to the Mining Industry

- This slide shows the most important tax provisions that apply to the various stages of mineral extraction and processing for the purpose of calculating federal income tax.

- At the exploration stage, grassroots exploration and predevelopment expenditures are accorded a 100% deduction for tax purposes in the year they are incurred. Unused deductions can be carried forward indefinitely.

- Development expenditures, which are considered less risky than exploration expenditures, are eligible for a 30% declining balance write-off. Such expenses are accumulated in a pool and amounts unclaimed for a particular tax year may be carried forward indefinitely.

- Physical assets acquired after the commencement of commercial production usually qualify for a capital cost allowance (CCA) of 25%.

- For assets purchased before the commencement of commercial production, the accelerated capital cost allowance (ACCA) can provide for an accelerated rate of depreciation of up to 100%. This generous provision is allowed for assets used at a new mine, for a major expansion and for capital expenditure programs exceeding 5% of gross income. The intent of the ACCA is to allow the full recovery of preproduction capital before paying any income tax.

- Operating expenses incurred after the start of commercial production are entitled to a 100% deduction in the year incurred.

- A corporation can carry non-capital losses forward for seven years or backward for three years.

- The resource allowance accounts for the nondeductibility of mining taxes by providing a 25% write-off against corporate income tax on resource profits. It effectively reduces the federal and all provincial corporate income tax rates, except British Columbia's, by 25%.

- Flow-through shares are unique to Canada. They allow companies (mostly junior mineral exploration companies) to raise funds even in the absence of revenue producing assets. Their "real assets" are mainly the tax deductions associated with their exploration expenses. They are allowed to pass or "flow" these deductions through to investors who purchase shares in the company. In addition to receiving a tax deduction, investors also stand to gain from successful exploration activities.

- For federal income tax purposes, contributions to provincially mandated mine reclamation funds are fully deductible in the year they are incurred.

- Most of these tax provisions also apply at the provincial level. In addition, many provinces offer special provisions to make investment in exploration, development, extraction and processing more attractive.

Corporate Income Tax Rates

(January 1997)

Federal Rate (Net of Resource Allowance): 21.84%

Province/ Territory	**Provincial Rate** (Net of Resource Allowance) (%)	**Combined Federal/Provincial Rate** (Net of Resource Allowance) (%)
British Columbia	16.50	38.34
Alberta	11.63	33.47
Saskatchewan	12.75	34.59
Manitoba	12.75	34.59
Ontario	10.13	31.97
Quebec	6.68	28.52
New Brunswick	12.75	34.59
Nova Scotia	12.00	33.84
Newfoundland	10.50	32.34
Northwest Territories	10.50	32.34
Yukon	11.25	33.09

3.5 Corporate Income Tax Rates

- As I mentioned earlier, both the federal and provincial/territorial taxing authorities impose corporate income taxes on mining, just as on any other type of corporation.

- The basic rate of federal corporate income tax is 38%. However, a 10% abatement is given to allow the provinces/territories room to levy their own corporate income tax. This brings the federal corporate income tax rate down to 28%.

- A 4% corporate surtax is added to that 28% to give a total federal corporate income tax rate of 29.12%.

- Now, for mining, I mentioned the existence of a special measure, the resource allowance, to account for the nondeductibility of provincial mining taxes.

- The resource allowance effectively reduces the federal corporate income tax rate by another 25%, which gives a final federal corporate income tax rate of 21.84% on the resource profits of mining companies.

- At the provincial/territorial level, statutory corporate income tax rates vary from 8.9% for Quebec to 17% for Saskatchewan and Manitoba. Once the effect of the resource allowance is taken into account, these rates vary from 6.68% for Quebec to 12.75% for the provinces of Saskatchewan, Manitoba, and New Brunswick. British Columbia does not permit the deduction of the resource allowance but allows instead a deduction of the mining tax paid, up to the amount of the resource allowance.

Mining Tax Rates
(January 1997)

Province/Territory	First Tier Tax Rate on Gross Income (%)	Second Tier Tax Rate on Net Profit (%)
British Columbia	2.0	13.0
Alberta	1.0	12.0
Saskatchewan	n.a.	12.5
Manitoba	n.a.	20.0
Ontario	n.a.	20.0
Quebec	n.a.	12.0
New Brunswick	2.0	16.0
Nova Scotia	1.0 to 2.0	15.0
Newfoundland	n.a.	16.0 (effective)
Northwest Territories	n.a.	3.0 to 12.0
Yukon	n.a.	3.0 and up

3.6 Mining Tax Rates

- Mining tax rules vary among provinces/territories. Mining taxes may be levied at the corporate level (Ontario, Quebec and Manitoba) or at the mine level (all other provinces).

- In some provinces, there may be a minimum royalty charge levied on a measure of gross income, in addition to the regular mining tax calculated on net profit.

- In most provinces/territories, it is possible to recover the initial investment before paying regular mining taxes. This generally includes expenditures on exploration, development and capital assets. Faster capital recovery is facilitated by the provision of tax holidays, concessionary tax rates or fast write-off rates.

- The mining tax rates shown here generally apply to the mining of base metals, precious metals and coal. They do not apply to industrial minerals, uranium or potash.

Section 4

International Competitiveness of Canada's Mineral Taxation Regimes

International Tax Burdens

Methods of Evaluation

- **Statutory Tax Rates**
- **Marginal Tax Rates**
- **Average Effective Tax Rates**

4.1 International Tax Burdens - Methods of Evaluation

- We have just briefly looked at the evolution of the Canadian tax regime for mining and at its current structure. I would now like to show you how competitive this regime is on an international scale.

- Comparing profit-based taxes and royalties among competing jurisdictions is a very complex operation because of the diverse nature of tax regimes.

- There are three approaches commonly used to compare taxation among different jurisdictions: the "statutory tax rate"; the "marginal tax rate"; and, the "average effective tax rate."

- Statutory rates are the actual rates enshrined in the tax acts of the various jurisdictions. Although a comparison of statutory tax rates is useful, tax analysts should not rely solely on this type of analysis to evaluate the tax competitiveness of a jurisdiction.

- The reason is that there are numerous corrections or adjustments which need to be applied to statutory rates to take into account the effect of surtaxes and automatic deductions before one can calculate the actual amount of tax payable by a company.

- As I alluded to earlier, in the case of Canada, the 25% resource allowance effectively reduces the federal corporate income tax rate from 28% to 21% (not to mention reductions at the provincial level as well). The federal income tax rate is further modified by applying the surtax which brings it to a total of 21.84%.

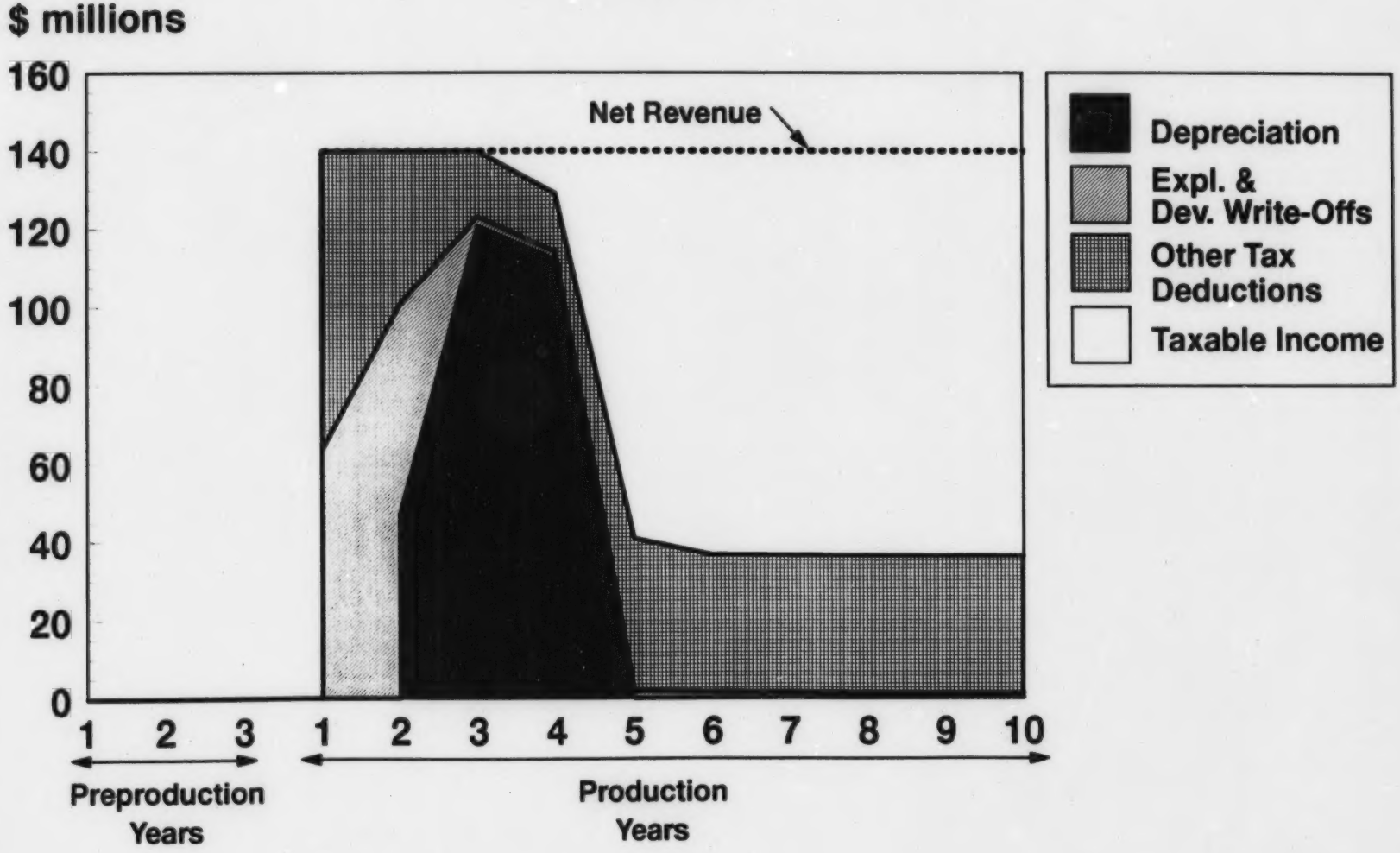
- Hence, marginal tax rates are more widely used than statutory rates to compare tax regimes.

- Unfortunately, the use of marginal tax rates causes many people to think that the Canadian corporate income tax system is more onerous than it really is. This is because marginal tax rates do not take into account the tax-deferral effect of accelerated tax deductions that are provided in Canadian mineral taxation regimes.

- A better measure of how onerous a tax regime really is can be obtained by using average effective tax rates. Average effective tax rates do take into account the effect of tax provisions (such as the accelerated capital cost allowance and other tax features) on the timing of tax payments.

- To illustrate this, I will use the case of a mining company located in the province of Ontario.

Impact of Incentives on the Tax Base
25 Percent Internal Rate of Return
(Ontario)



4.2 Impact of Incentives on the Tax Base - 25% Internal Rate of Return (Ontario)

- What you are seeing here is how the Canadian federal income tax system acts to reduce the tax base upon which the marginal tax rates are applied.

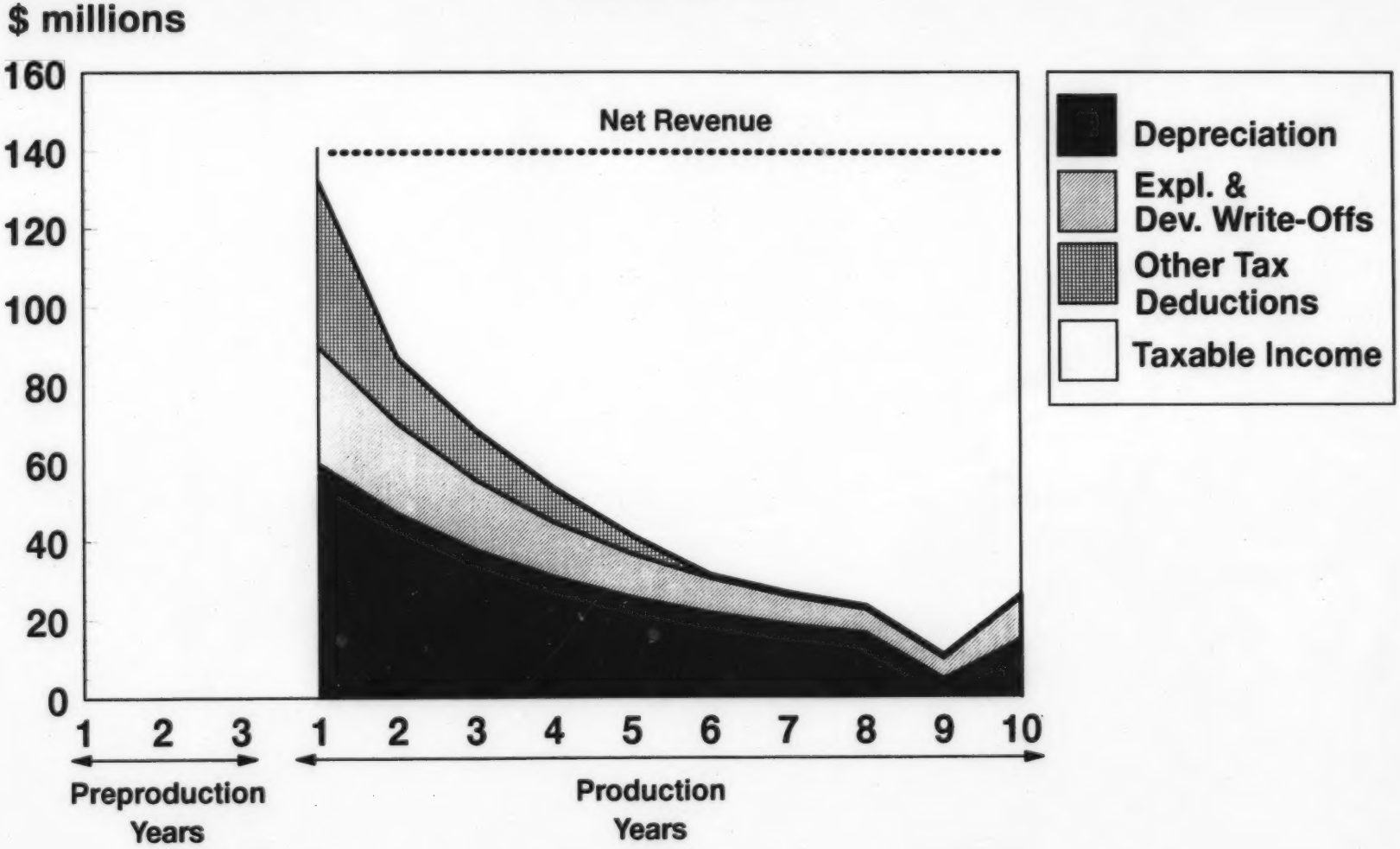
- The shaded areas represent the portion of net revenue which is offset by depreciation, exploration and development write-offs, and other deductions. The white area represents taxable income.

- In this case, we have chosen a profitable operation with a pre-tax internal rate of return (IRR) of 25%.

- For the first three years of production, no taxes will be paid in Ontario. In the fourth year, a very small portion of the tax base is subject to tax. This situation is made possible by the existence of generous and flexible depreciation and write-off rules that are designed to allow the deferral of any tax payment until capital costs are fully recovered.

- It is important to notice here that these features also extend to provincial income taxes, as well as mining tax regimes. In Canada, provincial mining tax regimes are based on profits, and many also feature tax holidays for new mines, and automatic deductions which further reduce the tax base.

Impact of Incentives on the Tax Base
25 Percent Internal Rate of Return
(Indonesia)



4.3 Impact of Incentives on the Tax Base - 25% Internal Rate of Return (Indonesia)

- We have taken the case of Indonesia for comparison purposes. Indonesia is a good example of an income tax regime that tries to match capital costs with revenues. Other countries with a similar tax structure, such as Chile, would lead to basically the same conclusions.

- Indonesia's tax rules, as they applied under the fifth generation Contract of Work (COW), give rise to the tax calculations which are shown on this graph.

- If a 25% IRR (before tax) is assumed, a mine will start paying taxes in Indonesia in the very first year of production. You will recall that the corresponding Canadian mine started to pay taxes only in its fourth year.

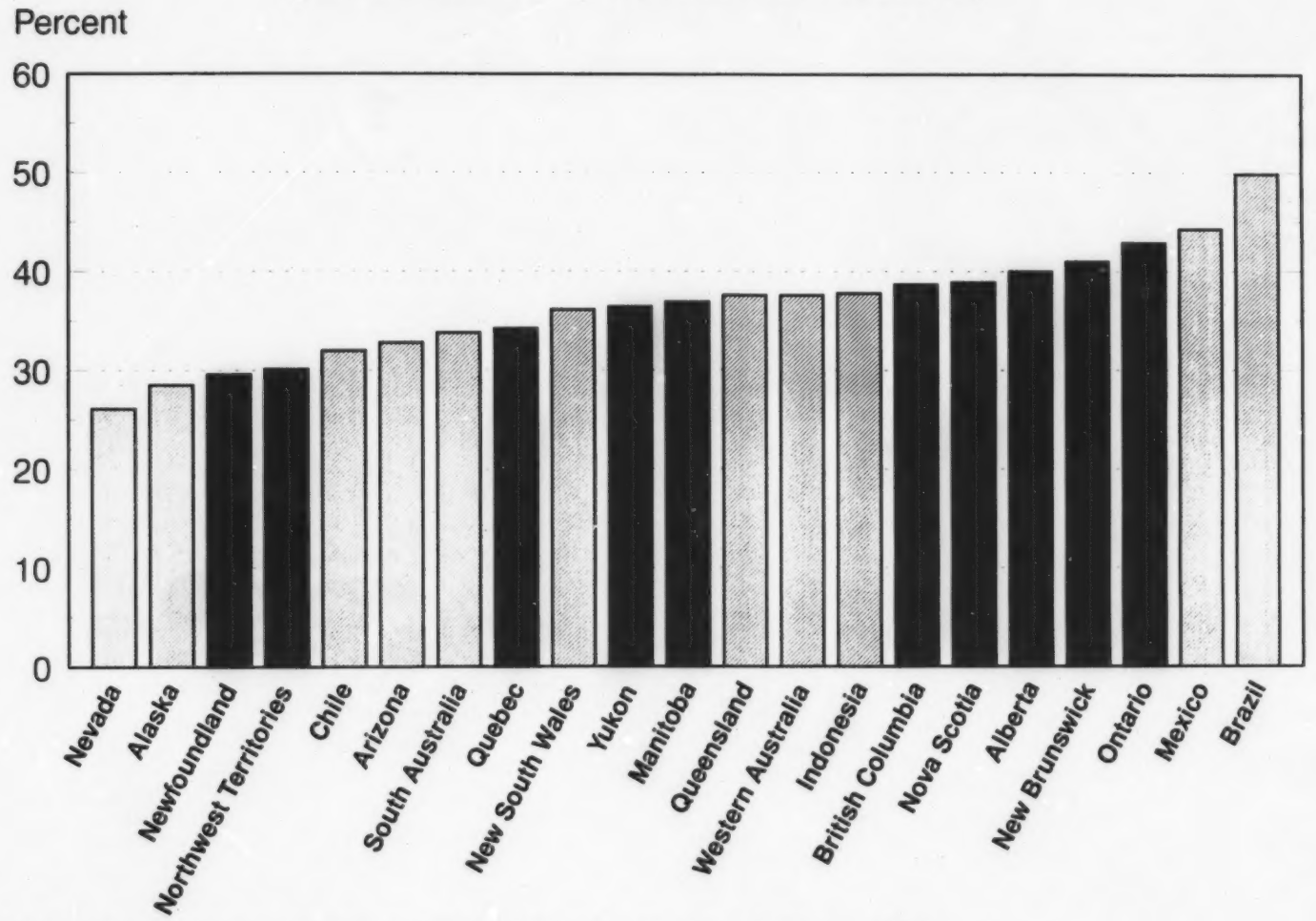
- What these last two charts show is that there are very significant differences in the timing of tax payments between a Canada-like regime and an Indonesia-like one.

- Canada offers a tax-free period that is three to four years longer than in Indonesia. On the other hand, once the Canadian project starts to pay tax, it faces a significantly higher marginal tax rate.

- Do companies prefer to have lower marginal tax rates but no upfront write-offs, or do they prefer to have higher marginal tax rates with fast write-offs and other upfront deductions?

- We would venture to say that it depends on how, in the two situations, the total tax burden compares, on a net present value basis, over the production life of the project. Such an evaluation is the subject of the next two slides.

Average Effective Tax Rates for Base-Metal Operations (25% Internal Rate of Return)



25% internal rate of return pre-tax, mine life of 10 years and discount rate of 7.5%.
Calculations are with respect to income taxes and mining taxes/royalties only. Revised for tax changes as of April 1994.
Source: Minerals and Metals Sector, Natural Resources Canada.

4.4 Average Effective Tax Rates for Base-Metal Operations (25% Internal Rate of Return)

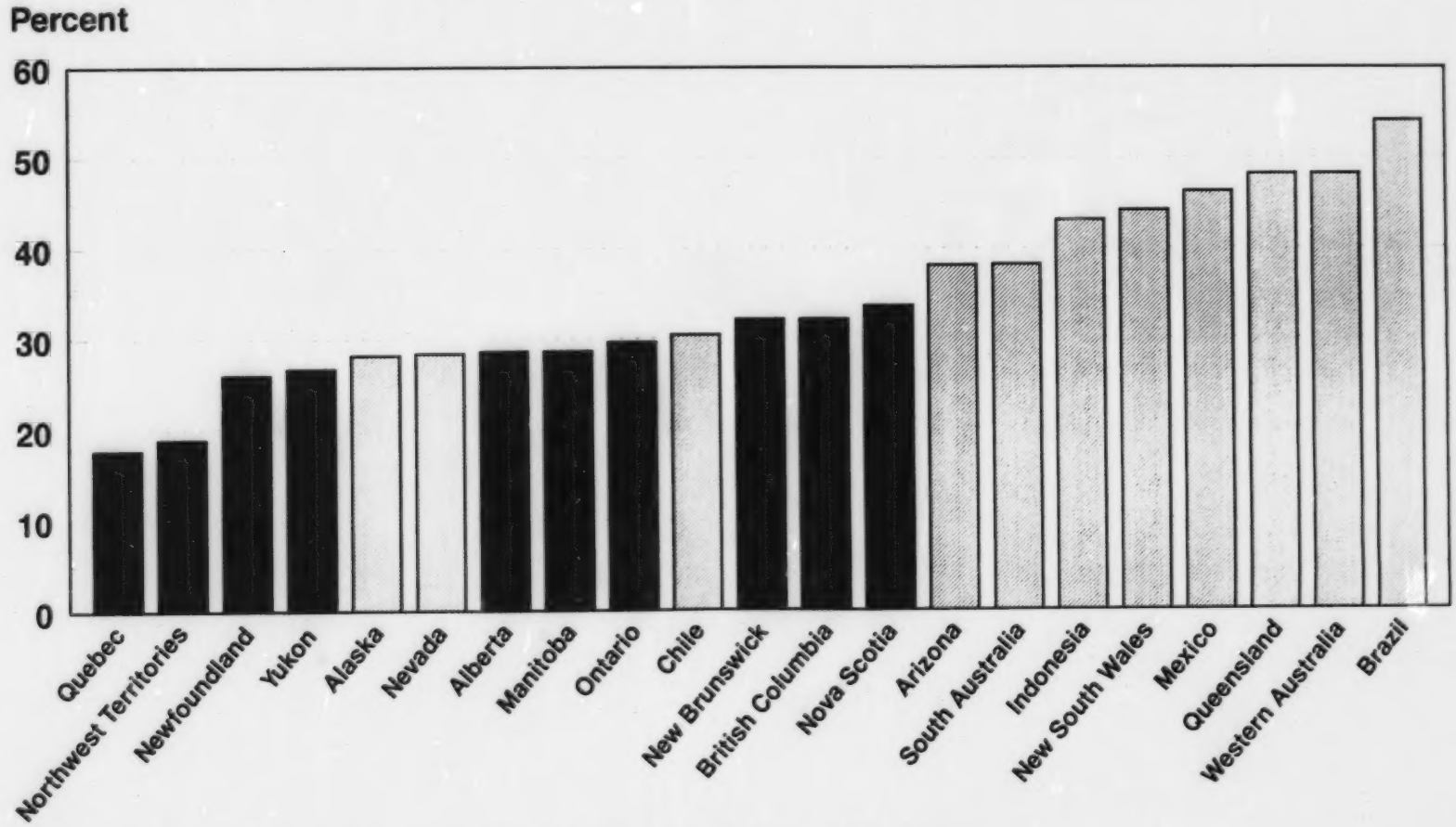
- Here, we have the comparative results for a 25% rate of return base-metal project for 21 jurisdictions. By the way, these results come from our calculations of 1994, and there have been some changes since. We intend to recalculate this table, but it is a mammoth task.

- The effective tax rates of countries like Indonesia or Chile that have no upfront deductions show very little differences from marginal tax rates.

- In contrast, Canadian effective tax rates are 10 to 15 percentage points lower than corresponding marginal tax rates.

- Even though the effective tax rates of some Canadian jurisdictions are rather on the high side, differences with main competitors are much less pronounced than would be suggested by a review of marginal tax rates.

Average Effective Tax Rates For Base-Metal Operations (10% Internal Rate of Return)



10% internal rate of return pre-tax, mine life of 10 years and discount rate of 7.5%.

Calculations are with respect to income taxes and mining taxes/royalties only. Revised for tax changes as of April 1994.

Source: Minerals and Metals Sector, Natural Resources Canada.

4.5 Average Effective Tax Rates for Base-Metal Operations (10% Internal Rate of Return)

- In the case of the 10% rate of return base-metal project, the effect of timing is much more pronounced. This is because capital cost write-offs represent a larger proportion of cash flow than is the case for the more profitable project.

- At this level of profitability, Canadian tax rates become among the most competitive by virtue of the very long tax-free period provided.

- Before leaving the subject of tax competitiveness, I should issue some caveats.

- This analysis does not cover nonprofit-based taxes (i.e., capital taxes, sales taxes, fuel taxes or payroll and employment-related levies), withholding taxes or mine reclamation requirements. As a result, we have not addressed the issue of the total tax burden imposed on a mine by a jurisdiction.

- As I have tried to show, one cannot make simple and unambiguous statements about whether a company in a certain jurisdiction is subject to a "high" or "low" level of taxation in relation to its competitors by simply referring to statutory, marginal or even average effective tax rates.

- The actual tax burden of a mine in a given jurisdiction (measured by the proportion of profit taken as taxes by governments) can vary greatly year to year due to a number of factors including: the age of the mine (e.g. have front-end deductions been exhausted or not?), and, profitability (did the mine turn out to be highly profitable or not?) etc.

- It is foolhardy for anyone to make blanket statements about tax burdens. It is extremely important to understand the complexities of taxation; hopefully, this analysis has provided some insights.

Section 5

Tax Features to Facilitate the Movement of Capital Into and Out of Canada

Stability of the Tax Regime

- **No Major Changes to Federal Income Tax Since 1987**

- **Resource Allowance Substantially Unchanged After the 1996 Review**

- **Recent Provincial Changes Characterized By:**
  - **Greater Harmonization with Federal Tax Rules**
  - **Simpler, More Flexible, Mining Royalty Regimes**

5.1 Stability of the Tax Regime

- After showing you the positive impact of upfront deductions on Canadian average effective tax rates, I would now like to look at other features of the Canadian mineral taxation regime that increase the attractiveness of investing in Canadian mining or of using Canada as a base from which to invest worldwide.

- Over the years, Canada has developed a mature tax system with rules facilitating the movement of capital into and out of Canada and the management of cross-border capital flows.

- The capital intensive nature and the inherent risks of the mining industry, and the long lead times from preliminary exploration to payback, call for a stable tax environment. The seventies and the eighties witnessed broad changes in Canada's fiscal regime; the 1990's have seen the federal and provincial governments reduce the number and significance of changes.

- At the federal level, no major changes have been made to the income tax system since 1987. The 1996 budget reflected a continuation of this trend by announcing that, after an extensive review, the resource allowance would be continued substantially unchanged. The Large Corporations Tax, which was introduced in 1989, is a tax on capital which falls outside the scope of this review. In any event, the financial impact of this new tax is mitigated to the extent that it applies only to capital in excess of $10 million and that it is fully credited against the 4% corporate surtax.

- Similarly, recent provincial changes are mainly adjustments to harmonize with federal tax rules (Ontario's phasing in of federal resource allowance rules from 1988 to 1993), and to provide more flexible and higher write-off rates, and generally more lenient (Manitoba 1994 and British Columbia 1994) mining royalty regimes.

- Proposed changes to the Northwest Territories and Newfoundland mining tax regimes highlight the Canadian way of dealing with two normally conflicting objectives: adequately taxing new projects and providing a stable and favourable climate for mineral investment.

- Earlier amendments to these two mining tax regimes had introduced incentives that were much more costly than anticipated, because of the unexpected coming into play of new, giant mining projects. The proposed adjustments have been designed to ensure that new projects pay their fair load of taxes while tax incentives are maintained, and even enhanced, for existing producers and for new smaller and less profitable mines.

- Before final changes are introduced, public consultations are held to give consideration to the concerns and suggestions of all interested parties.

Rules Facilitating Foreign Investment into Canada

- **No Restrictions on Foreign Exchange, and Repatriation of Capital or Profits**
- **Canadian Resource Tax Treatment Can Be Obtained by Incorporating a "Principal-Business Corporation"**
- **Equity Capital Can Be Repatriated Tax Free**
- **Withholding Tax Rates Are Low and Declining**

5.2 Rules Facilitating Foreign Investment Into Canada

- From the foreign investor's point of view, several features of Canada's legal and fiscal frameworks facilitate the planning and management of direct and indirect (portfolio) investment into Canada.

- First, there are no foreign exchange or currency controls in Canada. There are no exchange restrictions on borrowing from abroad, on the repatriation of capital nor on the ability to remit dividends, profits, interest, royalties and similar payments from Canada.

- A foreign investor can also gain access to the special tax incentives provided under the Canadian resource income tax treatment by incorporating a "Principal-Business Corporation" in Canada. A Principal-Business Corporation is a corporation whose principal business is directly related to one or more of the mining or oil and gas activities such as exploration, development, extraction and processing.

- By incorporating a Principal-Business Corporation, a foreign mining company can:

  - obtain additional financing using the flow-through share mechanism;
  - receive a 100% write-off and indefinite carry-forward for its exploration expenses and a 30% deduction for the cost of acquiring resource properties;
  - gain access to the accelerated capital cost allowance for capital costs on green-field mines, major expansions or capital expenditures in excess of 5% of gross income from the mine.

- Another attractive feature of Canada's tax system is the ability to repatriate equity capital **tax free at any time**. For example, a foreign company which invests in a Canadian subsidiary can take all of the amount invested out of Canada before having to pay Canadian taxes.

- By contrast, even when there are no restrictions on capital repatriation, other countries' tax regimes normally require that domestic profits be repatriated first, before equity capital. Usually the repatriation of such profits is subject to withholding taxes.

- The ability to repatriate capital before profits, in conjunction with other Canadian tax rules, means that an investor can defer the time at which he has to pay Canadian taxes.

- As far as the repatriation of profits is concerned, Canada is party to a long list of tax treaties with other countries. This network of treaties offers a wide range of opportunities for the foreign investor to repatriate Canadian profits with low, or no withholding taxes. In addition, Canada is following the Organization for Economic Co-operation and Development's (OECD) worldwide thrust to reduce withholding taxes.

Canada's Withholding Tax Rates for Selected Capital-Exporting Countries

Country	Dividends (%)	Interest (%)	Non-Copyright Royalties (%)
Australia	15	15	10
France [1]	10/15	10	10
Finland	10/15	10	10
Germany	15	15	10
Japan	10/15	10	10
South Korea	15	15	15
Sweden	5/15	10	10
Switzerland	15	15	10
United Kingdom	10/15	10	10
United States	5/15	10	10

[1] An unratified protocol with France will reduce the rate on direct dividends to 5% and eliminate the withholding tax on certain royalties.

5.3 Canada's Withholding Tax Rates for Selected Capital-Exporting Countries

- Two recently ratified tax conventions (U.S.-Canada and Sweden-Canada) are patterned to a large extent on the model double-taxation convention prepared by the OECD.

- Under such bilateral conventions, the following general rates of withholding tax will apply:

  - 5% on dividends paid to a parent company from a subsidiary;
  - 5% on branch profits (these profits are usually deemed to be repatriated);
  - 10% on interest;
  - 10% on royalties.

- The rate of withholding tax on other types of dividends is set at 15%. These conventions also provide for a number of exemptions in the case of interest, computer software, patents and know-how.

- This slide shows the withholding tax rates that have been agreed to between Canada and a number of capital exporting countries. These rates are the result of bilateral agreements. Therefore, they apply to money leaving Canada as well as to money leaving a specific country with Canada as a destination.

- In the case where two rates are shown, the lower one applies to companies/investors that hold a specified minimum percentage of shares in the entity upon which withholding taxes are levied.

- For France, Finland, Sweden, the United Kingdom, and the United States, the lower rate applies to dividends beneficially owned by a company that controls, directly or indirectly, at least 10% of the voting shares of the payer, or 10% of its voting power. For Japan, the lower rate applies to dividends owned by a company that holds at least 25% of the voting shares of the payer.

- Canada is working hard to renegotiate all bilateral conventions which do not currently adhere to OECD standards. For example, an unratified protocol to the France treaty will reduce to 5% the rate applying to dividends.

Rules Facilitating Investment From Canada to Foreign Locations

- **Interest Deduction Rules**
- **Foreign Affiliates Rules**
- **Deductions of Foreign Exploration and Development Expenses**

5.4 Rules Facilitating Investment from Canada to Foreign Locations

- In the case where a subsidiary in Canada of a multinational corporation invests abroad, directly or through its own foreign subsidiaries, there are a number of attractive features in Canada's income tax legislation, including:

(i) *Interest Deduction Rules*

Canada's tax rules for the deduction of interest expenses are favourable to investment made outside of Canada. These rules allow the deductibility in Canada of interest incurred on borrowing for investment in the shares of a wholly or partly owned foreign subsidiary, even where the dividends paid by the foreign subsidiary are exempt from Canadian income tax.

(ii) *Foreign Affiliates Rules*

The foreign affiliates rules define the Canadian income tax treatment of earnings that are generated by foreign affiliates that are wholly or partly owned by a Canadian company.

Generally speaking, the foreign affiliates rules can serve to foster the use of a Canadian company for investing outside of Canada and for managing cross-border capital flows.

For example, active business profits generated by a subsidiary operating in a country with which Canada has a tax treaty can be repatriated to Canada free of Canadian income tax. Even though dividends received from subsidiaries operating in non-treaty countries are taxable in Canada, the ordering rule for dividends paid by a foreign affiliate allows Canadian corporations to defer Canadian tax on a taxable surplus by permitting tax-exempt dividends to be distributed first.

(iii) *Foreign Exploration and Development Expense Deduction Rules*

Finally, a Canadian company which invests directly in a foreign mining project and incurs exploration and development expenses can deduct annually, in Canada, a minimum of 10%, and up to 100%, of its unclaimed foreign exploration and development expenses, to the extent of its foreign resource income. Other countries have more stringent limitations on the deductibility of foreign exploration and development expenses.

All of a Canadian company's foreign exploration and development expenses are accumulated in one tax "pool". This means that, for tax purposes, the company does not have to keep track of these expenses on a property-by-property basis, and not even on a country-by-country basis. Accordingly, proceeds from the sale of a foreign resource property, which constitutes foreign resource income, can be sheltered against Canadian tax by the total amount of a company's unclaimed foreign exploration and development expense pool.

Section 6

Lessons from the Canadian Mineral Taxation Experience

Lessons from the Canadian Experience

- **Keep Tax Rules as Simple as Possible**
- **Clearly Explain Tax Regime to Investors**
- **Aim for Stability and Continuity in Tax Rules**
- **Allow Recovery of Capital Before Imposing Taxes**
- **Do Not Impede the Cross Border Flow of Capital**
- **Graduated Tax Rates Discourage Further Investment**
- **Ensure that Tax Preference Measures Are Sustainable Prior to Their Introduction**

6.1 Lessons From the Canadian Experience

- Because of the variety of tax structures prevailing around the world, the exact evaluation of a country's relative tax burden is a very difficult exercise, but one that investors always want to be able to perform. The difficulty arises with the degree of complexity of a particular tax regime. Complex rules that are not well explained and understood may deter investment to the extent that they create uncertainty for investors. While there may be some justification for complex tax rules (particularly in the context of federations where there may be multiple levels of taxation), the onus is on tax authorities to ensure that these rules are properly communicated and explained.

- Stability and continuity in the tax rules are essential elements of a positive climate for mineral investment. Uncertainty about future tax liability adds to the inherent risks of the mining industry and increases the hurdle rate of return required by investors. Major Canadian tax reforms in the mid 1970's and in the mid 1980's created uncertainty and had a negative impact on mining investment for several years.

- The inherent risks of the industry must also be recognized in the taxation regime. Because mining projects typically involve large investments which are recovered only after a number of years, investors are particularly sensitive to differences in the payback period when considering alternative investment opportunities. One of the significant factors affecting payback is the tax structure. Hence, regimes that impose onerous tax payments before invested capital has been fully recovered may deter or delay desirable mining developments by unduly extending the payback period.

- For a foreign investor, another factor affecting payback is the ability to repatriate his investment and profits. Canada's mining industry attracts large amounts of foreign capital partly because Canada's tax regime does not impede the cross border flow of investment capital and all forms of corporate remittances.

- To attract mining investment, a country's tax regime should not be perceived as predatory. High marginal tax rates tend to discourage the established producers' drive to improve economic efficiency and may hamper their ability to reinvest in undeveloped projects. Since 1972, the Canadian corporate income tax system has always featured a flat tax rate applied to all levels of income. This is also currently the case for most provincial mining tax regimes. While some provinces have experimented with graduated mining tax rates and rate-of-return royalty regimes, they were not aimed at capturing a large proportion of the "economic rent", except in specific instances for a short period of time in the mid-1970s.

- Providing tax preferences that are not justified by sound economic principles may prove to be counter-productive in the long run: they will introduce distortions which will undermine the stability of the tax system. When these preferences are eventually removed, the public perception will be that the government is "taking the hard line" on sectors which received preferential treatment and that new investments are unwelcome.

Appendix

Federal Tax Provisions Applying to the Mining Industry

Federal Tax Provisions Applying to the Mining Industry

The following section explains in more detail the federal tax provisions that were highlighted in the first part of this paper. These provisions exist at the federal level for purposes of corporate income taxation and apply specifically to the mining industry, not to the economy in general. However, the reader should note that provinces and territories also have special tax provisions for mining, both at the corporate income tax and at the mining tax/royalty levels.

For a comprehensive review and assessment of the tax rules applying to mining activity in a particular Canadian jurisdiction, it is recommended that investors seek the advice of specialized accounting or legal firms and of relevant provincial/territorial government authorities.

Tax Treatment According to Stage of Production

For taxation purposes, mining activities are divided into three distinct stages: extraction; processing; and, semi-fabrication and fabrication. The extraction and processing stages, which include concentrating, smelting and refining, are given special treatment under the corporate income tax regimes of both the federal government and the provinces/territories.

At the federal level, this special treatment includes the following tax provisions: Canadian Exploration Expenses (CEE); Canadian Development Expenses (CDE); capital cost allowances (CCA); accelerated capital cost allowance (ACCA); resource allowance; flow-through shares; deduction for mine reclamation trust fund contributions.

The semi-fabrication and fabrication of metal products are considered manufacturing activities. As such, they are accorded the same general treatment as other manufacturing activities in the economy.

Canadian Exploration Expenses

Because of their high risk nature, grassroots (primary) exploration and predevelopment expenditures are accorded a 100% deduction, for corporate income tax purposes, in the year that the expenditure is incurred. Any unused balance of Canadian Exploration Expenses (CEE) in a particular year can be carried forward indefinitely and claimed in a later year at the election of the taxpayer.

Grassroots CEE includes all expenses incurred to determine the existence, location, extent or quality of a mineral resource in Canada. Examples of such expenses include prospecting, geophysical and geochemical surveys, exploration drilling, trenching, test pits, sampling and feasibility studies.

Preproduction development CEE includes the intangible costs of bringing a new mine into production in Canada. This includes such costs as those incurred for overburden removal, shafts and haulageways. An expense can only qualify for preproduction development CEE if it was incurred prior to the point of commencement of production in reasonable commercial quantities.

Canadian Development Expenses

Federal taxing authorities consider mine development expenses less risky than exploration and predevelopment expenses. Accordingly, the treatment accorded to Canadian Development Expenses (CDE) is a 30% declining balance write-off.

Eligible expenditures for CDE treatment include such costs as those incurred to acquire a Canadian resource property (mineral rights), the costs of mine shafts, main haulageways, and similar underground workings that are undertaken after the commencement of commercial production.

CDE are accumulated in a pool called Cumulative Canadian Development Expenses (CCDE). The taxpayer can deduct up to 30% of the unclaimed balance in that pool at the end of each year. Unclaimed balances may be carried forward indefinitely.

In the case where a corporation does not have taxable income against which to claim CDE, the CDE can be used to create a non-capital loss. This non-capital loss can then be carried backward or forward to taxation years where the corporation can use the deduction to reduce its taxable income.

Capital Cost Allowance

When an asset is acquired, its cost is included in an asset class or pool. There are different asset classes (pools) for the various categories of depreciable assets. The CCA rates vary according to the asset class under which the asset falls.

In general, the balance in a pool is determined by adding, to the previous year's balance, the sum of the costs of acquired properties that are available for producing income and subtracting the proceeds from asset dispositions and any tax credit claimed. The half-year rule applies. As such, only one-half of the costs of assets acquired in that particular taxation year can be added to the pool, the rest can be added to the next year's total.

The CCA is computed by multiplying the pool balance by the appropriate statutory rate for that class of assets. The CCA amount thus obtained is a maximum. The taxpayer may choose to use other forms of deductions which are about to expire instead of using the full amount of CCA available.

Using the declining balance method, the amount of CCA used as an income tax deduction is subtracted from the pool. The balance left in the pool is carried forward to the next year where adjustments will be made for acquisitions, disposals and tax credits before calculating the CCA for that year.

The point of commencement of commercial production is an important criterion in determining the rate at which physical assets are depreciated for tax purposes.

Assets purchased before the commencement of commercial production can qualify for an accelerated capital cost allowance (ACCA) of up to 100% (see explanation below). Mine-related assets that were acquired after the commencement of commercial production usually qualify for a capital cost allowance (CCA) rate of 25% on a declining balance basis.

The 25% rate applies to Class 41 (b), which includes most mining assets such as mine buildings, machinery, motive equipment, processing assets (concentrator, smelter, refinery) and social assets (hospital, school, airport, fire hall, etc.), loading and unloading assets, electrical plants used for mining etc. Other than Class 41, only a few classes of assets apply to mining according to the *Income Tax Act*.

Accelerated Capital Cost Allowance

In addition to the 25% rate of depreciation accorded under the CCA, the accelerated capital cost allowance (ACCA) can provide for an accelerated rate of depreciation of up to 100%. To be eligible for that accelerated depreciation, however, assets must have been acquired before the beginning of commercial production, for major expansions, or (since 1996) for investment expenditures in excess of 5% of gross income from the mine.

The ACCA allows the full recovery of preproduction capital costs before paying any income tax. As such, this tax provision is of great benefit to protecting the early income of a mine. Essentially, the ACCA acts to provide the full write-off of capital costs before a mine starts to pay income tax.

The amount of ACCA that can be claimed in a year is equal to the balance of undepreciated capital cost in the class, but in the case of a new mine or a major expansion, it cannot exceed the full income of the new mine or the new expansion. The amount claimed is optional in that any amount can be claimed up to the allowed maximum rate.

In the calculation of taxable income, the ACCA deduction is taken after the normal CCA, but before the resource allowance, CEE and CDE.

Resource Allowance

The resource allowance is a provision in lieu of deductibility of mining taxes in the calculation of corporate income taxes. It is essentially a 25% write-off against federal and provincial corporate income taxes on resource profits.

Resource profits include income from extraction, concentration, smelting and refining, and from royalties. Income related to the disposition of property is not considered a resource profit. For the purposes of calculating the resource allowance, no deduction from resource profits needs to be claimed for interest expenses, CEE and CDE. These deductions are taken after the resource allowance.

At the federal level, the overall effect of the resource allowance is to reduce the corporate income tax rate on resource profits by another 25%. This results in a real corporate income tax rate of 21.84% (including a 4% surtax) on the resource profits of mining companies.

Flow-Through Shares

The flow-through share mechanism has been a longstanding and *unique* feature of the Canadian regime for mining and oil and gas taxation.

Under this mechanism, companies that issue flow-through shares are allowed to pass, or "flow-through", the tax deductions associated with their exploration expenses to the investors who purchase the flow-through shares. These investors, provided they pay income taxes in Canada, can then claim these deductions on their own tax returns.

Therefore, companies that have no taxable income (as often is the case with small exploration companies) are able to use their deductions to attract and raise equity capital. Small mineral exploration companies (the juniors) are numerous in Canada and are often the initial discoverers of new exploration plays. These companies have been using the flow-through share mechanism extensively for years to finance their exploration activities.

For the individual investors, the advantages of investing in flow-through shares can be two-fold: (i) they receive a 100% tax deduction for the amount of money they invested in the shares, and (ii) they stand to see the value of their investment appreciate in the event of successful exploration.

In its 1996 budget, the federal government introduced a number of measures designed to improve the effectiveness of the flow-through share mechanism. For mining, the most significant change affects the so-called "look-back" rule. The rule was modified to allow exploration expenditures renounced to investors to be incurred by the issuer up to a full year (rather than only 60 days) after the end of

the calendar year in which the funds were raised. Also, the budget introduced tightening measures to ensure that flow-through shares be used only to finance more risky expenditures. The cost of acquiring mining properties are no longer transferable to flow-through share investors.

A significant amount of the increasing exploration activity in Canada in recent years has been financed by flow-through shares. In the last three years alone, more than $350 million was raised through the flow-through share mechanism.

Quite often, flow-through shares provide exposure to the most interesting exploration plays in the country. Many of the companies currently exploring in the neighbourhood of the Voisey's Bay nickel-copper deposit in Labrador, and in the Northwest Territories for diamonds, are using flow-through shares to finance their activities.

Many mines have been found with the help of flow-through money. Some well-known examples include the Louvicourt copper-zinc mine, the Eskay Creek gold-silver mine, the Troilus gold project, and the Kemess South gold-copper project.

Mine Reclamation Funds

Some provinces/territories have set up mandated mine reclamation funds to provide the financial assurance that sufficient financial resources will be available to restore mine sites to environmentally acceptable conditions once the mining operations are ended.

In order to recognize this expenditure in the calculation of taxable income, the federal government introduced a measure, in 1994, to provide a full deduction for contributions into provincially-mandated mine reclamation trust funds. This 100% deduction is available for the year in which the contribution is made. Interest in the funds is taxable and any excess withdrawn from the fund that is not used for reclamation purposes is taxable as well at the time of withdrawal.